INCOME STRUCTURE IN AMERICA TODAY

[HE]ARING

[B]EFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JUNE 8, 1994

Serial No. 103–24

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE

80–331 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044741-0

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INCOME STRUCTURE IN AMERICA TODAY

WEDNESDAY, JUNE 8, 1994

House of Representatives,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., Room 210, Cannon House Office Building, Hon. Martin Olav Sabo, Chairman, presiding.

Members present: Representatives Sabo, Coyne, Kasich, Shays, Smith of Texas, Allard, Hobson, Lazio, and Smith of Michigan.

Chairman Sabo. The House Budget Committee is in session for a hearing on income structure and employment issues in America today.

I would like to welcome the distinguished members of our panel. Our witnesses this morning, all experts on labor compensation, are: Mrs. Audrey Freedman, an economic and human resources consultant from New York City; Robert J. Gordon, Professor of Economics at Northwestern University; and Marvin Kosters, resident scholar and Director of Economic Policy Studies at the American Enterprise Institute.

For several years, I have been very concerned about the growing disparities in income between the average wage earner and the upper income executive and professional class in this country. As I have discussed this problem with various experts, I was assured that it would abate when our productivity growth improved and the economy started to grow in a healthy way.

Today, we are seeing just that type of improvement in productivity, but we continue to experience what I believe to be a very unhealthy gap in wages between the top and the bottom. For this reason I have asked a panel of experts on the subject to come and visit with us about this problem.

In most ways, we have seen impressive economic improvement since January of 1993. We have added 3.1 million jobs to private nonfarm payrolls. Inflation remains at the lowest rate since 1986 and core inflation is the lowest since 1972.

Over the last four quarters, productivity has grown 2.6 percent, well above the 1 percent average of the 1980's. Yet, the average American has to work harder just to stay in place. Real compensation for workers has increased less than 1 percent while productivity has grown almost three times as much. In fact, as the graph shows, the gap between productivity and real compensation has been widening since the mid–1980's, and it continues to widen. A large share of the economy's productivity gains is not going to its workers.

Further, the distribution of income continues to become more unequal, eroding the sense of a shared national destiny that has been one of America's greatest strengths. And now we are being told by many, including some in the Federal Reserve System, that we cannot afford to make any more progress in reducing unemployment because that might mean that workers would start to get bigger wage increases.

I have asked our panel to help us make sense of these recent developments. I might add that we intend to continue this discussion with Federal Reserve Chairman Alan Greenspan at a hearing on June 22, when we will be asking his views on the relationship between interest rates, wages, employment and inflation.

I might add that this issue also has relevance to the ongoing responsibilities of this committee because I think it is quite clear, as the lower end of the wage spectrum continues to be stagnant, the public sector is increasingly asked to provide support in a variety of fashions below wage workers, whether it is through housing assistance, food stamps, and clearly one of the core issues in the health care debate is making health care affordable to people who can't pay for it through their normal wages. So, again, I welcome the panel to our committee, and we look forward to hearing your views.

Mrs. Freedman, would you like to speak first? I think we will go Mrs. Freedman, Dr. Kosters and Dr. Gordon.

STATEMENTS OF AUDREY FREEDMAN, ECONOMICS AND HUMAN RESOURCES CONSULTANT, NEW YORK, NEW YORK; ROBERT J. GORDON, PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY; AND MARVIN KOSTERS, DIRECTOR OF ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mrs. FREEDMAN. Thank you very much, Congressman Sabo. I am going to talk primarily about the institutional changes or the practical changes that have happened in the labor market and particularly with regard to wage setting in the past decade. I believe that at unemployment rates of 6 percent or more, there is more competition for jobs than previously and secondly, there is far less of a structural tendency for imitative, infectious wage increases to spread through the whole economy.

Imitative wage setting is much less prevalent than it was in the 1970's. Remember in the 1970's, union contracts in autos, in steel set the pace for the whole country. They set the pace in the metal-using industries and then in other industries and across the country, and they even became models for nonunion wage setting. So we had an infectious wage pattern really arising in union contracts. And those contracts themselves were automatic engines of wage increases.

They contained cost-of-living clauses that automatically escalated wages as inflation grew. That really hit hard in the mid 1970's. They had practically automatic annual increases in addition to the COLA of about 3 percent, and that became part of the mechanical norm, and then in addition they had benefit increases that essentially were automatic. They were out of the control of the parties, because benefits were expressed in real terms in contracts. So we

had a machinery of wage inflation in place that not only prevailed in union bargains, but affected all nonunion wage settings as well. Everything was essentially automatic and formula-based.

By the 1980's, those union patterns began to break up, because of competition in the metal working industries and in the auto industries. Foreign competition at first, and then it became domestic competition. Patterns across industries broke up and then patterns between industries broke up during the mid–1980's.

During the 1980's also, large, old, highly hierarchical corporations were forced to sell off unprofitable units. They shut unproductive lines of business or lines of business where essentially they weren't selling. That is even happening today. Yesterday, the Sara Lee Corporation decided to shut down some of its ladies hosiery-making facilities, because they are not selling. So they shut unproductive lines of businesses. They cut out whole layers of the wage hierarchy, the administrative networks within the corporation, incidentally giving first level employees more responsibility for their own production.

The buzz word is empowerment, but essentially it is pushing responsibility down to the first level, and eliminating the supervisory layers of large hierarchy corporations.

So what this did was it shot holes in the corporations' traditional salary pyramids and the salary progressions and the career paths, all of those words connoting mechanical wage increases, almost formula-based wage increases. When the corporation began to fall apart or disassemble itself, all of the structure of these wage increases, automatic in many cases, in most cases, was downgraded, pulled apart and could not be recreated. It made wages less automatic throughout the whole corporation. At the same time, corporations had to develop new standards for setting pay and they began to use more highly performance-related criteria. Performance-related, productivity-related pay began to be much more intensively practiced in the mid–1980's.

Reorganization and downsizing spit more people out on to the competitive external labor market, out of the interior labor market—that automatic labor market in which progressions and promotions in many cases were automatic and certainly salaries were. In the open labor market, wages are reset in a much more competitive atmosphere. I think that kind of spitting out will continue indefinitely.

Each time the individual returns to the open labor market his or her wages are reset to correspond to demand for that particular individual skill, whether we are talking about a manager, a generic manager, or one specific to an industry or a corporation whose primary skills relate to that corporation, or a production worker, or a skilled technician. So wages are then reset to correspond to what a market, an open, free market would provide for that bundle of skills, and also the presence of other job competitors in that free market. So there is much more competition in the labor market and people are being forced to go through that competition much more frequently.

There are also more kinds of employment than we had two decades ago, more ways to become reemployed than we had two decades ago. There is more self-employment, free-lancing, consulting,

self-employment in start-ups of new kinds of enterprises. There is more temporary work, more contract work, contracting out to business services, small business services or large ones; contracting out to specialist firms. There is more part-time work, part-week, part-year work. All of these provide more ways to become reemployed than ever before.

So since job mobility has increased manyfold because of all of this leaving-and-returning in the labor market, you would think there might be a tendency toward higher unemployment, because of the presence of so many people cycling in and out. Essentially more volume searching for jobs; therefore, higher unemployment. But there is a counteracting trend, and that is all of these newer ways to work or newer ways back into an employment relationship or a contractual relationship. This trend would tend to lower the amount of unemployment. So these two are in balance at all times.

People who lose a job find that they can, if they want to, rebuild their skills or at least keep their skills current, one way or another. They can add new skills; they can develop new contacts, and eventually if they want, they can become reemployed in some relatively permanent job. I say relatively because I don't believe we will ever return to the rigidities and the securities that prevailed before the 1970's ever again.

[The prepared statement of Audrey Freedman follows:]

PREPARED STATEMENT OF AUDREY FREEDMAN, ECONOMICS AND HUMAN RESOURCES CONSULTANT

There have been some profound changes in the operation of the employment market, and in wage-setting behavior, since 1980. They have been forced by intense competition from abroad and from the de-regulation of major sectors of U.S. industry. To summarize these changes:

1. Wage-setting is much less imitative. The style of the seventies, with national union contracts setting the model, with all employees expecting to be made whole for inflation, has been replaced by wage policies closely geared to the competitive local labor market. Passed-on wage inflation is gone.
2. Industry and firm restructuring has changed the internal dynamic of compensation practices, demolishing traditional pyramids and progressions. Automatic career progressions are gone.
3. Lifetime careers within the same corporation are less common. More likely is the mid-career job shift, or several changes within a working life. Each time the job changes, an individual goes into the competitive labor market again, and his or her value (labor price) is reset.
4. There is generally more flexibility in the entire labor market, more kinds of employment relationships at all phases of the business cycle. In plain terms, there are more freelance jobs, limited-term project work, self-employment opportunities, part-time/part-week/part-year jobs than previously existed in the private economy.
5. Since job mobility has increased many fold (point 3), there might be a tendency toward higher unemployment. However, this is counteracted by greater variety among potential employment relationships (point 4). Therefore, it is easier for a person who has lost a job to (a) keep skills current, (b) add to skills, experience, and contacts, and thus (c) find new employment.

The rest of my testimony will cover these five points in somewhat more detail.

Point 1.

During the post-war decades from 1950 through 1970, there had been an increasing trend toward imitative wage-setting in the U.S. economy. Union bargains in heavy industry were watched and considered important indicators for compensation policies throughout the economy. As John T. Dunlop said, "We have reached, the stage where a limited number of key bargains effectively influence the whole wage structure of the American economy." (Ross, Arthur M., *Trade Union Wage Policy,*

Berkeley, University of California Press, 1948.) By the 1970's, compensation policies patterned on the wage-leadership principle had included cost-of living mechanisms that *automatically* escalated the wage structure; general increases on an annual basis, often set at 3%; extended unemployment supplements, and other fixed-cost elements. The inclination to go along with this structure was found in non-unionized industries across the country, to the extent that they held sufficient, uncontested market power.

Competition for U.S. manufacturing began to grow during the '70's, and to cut into our market share very heavily by the early 1980's. Competition arising in deregulation startled the airline, trucking, and telecommunications industries in the early '80's as well. It was possible to foresee that patterns of wage imitation would break up under the pressure of that competition. ("Last Rites for Pattern Bargaining", Audrey Freedman and William Fulmer, *Harvard Business Review*, vol. 60, March-April, 1982; Audrey Freedman, "A Fundamental Change in Wage Bargaining," *Challenge*, July-August, 1982; Audrey Freedman, "How the 1980's Have Changed Industrial Relations", Monthly Labor Review, U.S. Bureau of Labor Statistics, vol. 111, #5, May 1988.)

Obviously, long-ingrained practices do not disappear in a flash. It took a decade or so. By now, compensation policies are indifferent to "the" union settlement. (see, for example, *Pattern Indifference: The Response of Pay Setters to the 1993 GM-UAW Settlement* by Christopher L. Erickson and Daniel J.B. Mitchell, Working Paper Series #274, Institute of Industrial Relations, University of California at Los Angeles.)

Increasingly, wage levels are set with an eye to the competitive rates found in the local labor market, one skill bundle (occupation) at a time.

Point 2.

In the past few years, industry has been eliminating layers of supervision and many overhead staff functions. Again, this is a response to the need to cut costs in a more competitive market. It is also designed to allow a large, complex corporation to adapt quickly to changing market conditions.

Taking out layers and eliminating non-performing business units has demolished the solid-as-concrete pay structures within the corporation. These elaborate, interlocked pay systems were a little like erector sets. They could be lifted whole—and were, for example, by a fixed percentage (of 6 percent or so) in 1973. However, if you take out a few pieces of an erector-set construction, it falls apart.

The other structural elements of pay systems that have been undermined are mechanical wage progressions, whether they are based on step-wise promotions or simply on time in service. Pay is much more of an individualized matter, less of a "mass" level. There is a much stronger connection, now, between individual pay and performance or productivity.

Point 3.

Lifetime employment security for lower-level workers, and career ladders for supervisory and management employees, is fading rapidly. Competition is forcing companies to change their operation and their organization with much greater frequency than ever before—or, slowly go out of business.

This throws people back out of the "internal labor market" into the competitive labor market. In effect, their wages are re-calibrated as they seek new employment. To the extent that their value to a former employer was based on their specific knowledge of that firm, or to their personal relationships within that firm, they will command a lower wage from any new employer.

If a former employer was paying above-market rates for any reason, in fact, an individual losing such a job is going to experience distress and downgrading of his or her pay level. This would be true, for example, at a manufacturing plant where a union rate has lifted unskilled labor into $35-an-hour heaven. Competition may force the plant to close; the unskilled may find only service jobs are available, at pay rates of $6 to $8 an hour.

Point 4.

There are more ways to work than previously. In fact, there is so much variety and dispersion that measurement becomes almost impossible. (The reason for this is that, in order to measure, first you must define precisely; then you must hold that definition constant over a period of time. Our statistical measuring agencies can hardly keep up with the rapidity of change and the blurring of what were once clear-cut and static definitions.)

Some of these new working arrangements are easy enough to see in professional and technical employment. Consultants, professors of economics and engineering, designers and decorators, accountants—it is so well understood that they work in

a variety of relationships that we hardly find it remarkable. Those combinations are spreading out to more and more managerial, professional, technical, and administrative work, as well as to service and office support occupations.

Why do employers use these more fluid working arrangements? Again, because competition forces them to cut costs, raise productivity, and above all to change their operations on a dime when necessary.

The linkage between cutting costs and raising productivity is this: productivity is output per hour worked (and paid). If your business operation requires an intense concentration of work into one four-week period, you do not want to have hundreds of people sitting around for the rest of the year. Or, if your business is attempting something new, you may only try it if you can hire on a short-time, or "no promises" basis. Or, if your service business has peak demand only during the early evening, you cannot afford to pay a full day's wage to the supplemental staff. So, having people at work only when they are producing output—and not having them there when no output can occur—raises productivity.

As I pointed out when I coined the term "contingent" workers, the use of these flexible working arrangements allows an employer to provide somewhat more security to his regular workforce (quotes on pages A-4 through A-6, *Daily Labor Report*, July 18, 1985, Bureau of National Affairs). It also allows him to be more enterprising and resourceful in exploiting new opportunities.

Thus the existence of extremely flexible working arrangements represents a great competitive advantage for U.S. companies over our international competitors. The cost of innovation is lower in our less-regulated labor markets. Our speed of adjustment, for industry and for workers, is higher. Labor mobility is good enough to accommodate necessary industrial shifts. If this committee were to study the rigidities of European labor markets (imposed by regulation or by tradition), or the misplacement of labor in former communist countries, it would appreciate the advantages that our flexibility provides.

Point 5.

With all of this mobility, there is a good deal more cycling through jobs and job changing. This would tend to raise unemployment.

Counteracting this tendency is the fact that there are many more ways to find work, many and varied strategies for keeping some paychecks coming in. Thus, losing a job does not mean that the only way to regain a job is to find a permanent, full-time position. This has the effect of reducing the amount of time spent in unemployment (that is, searching for work).

When the whole economy is in recession, more people are "somewhat less than fully employed"—but they are working. As a recovery develops, they become "more employed".

For an individual, it is much easier to stay current in her skills by working in any arrangement she can find. It adds to skills, adds new experience, and increases contacts with employers and colleagues. And, it makes some money.

For the whole economy, any reduction in idleness represents an increase in Gross Domestic Product per person, as well as a reduction in transfer payments.

Increased cycling through repeated periods of employment and unemployment also creates a constant competition for jobs that does, I believe, effectively *lower* the non-accelerating inflationary rate of unemployment (NAIRU). I pointed this out in a speech before the Joint Economic Committee and others at a gathering celebrating the 40th anniversary of the Employment Act of 1946. Unfortunately, some academic speakers were so annoyed at my first point (the reduction in wage patterning and imitation), that they never noticed my conclusion that this signified a considerable reduction in the "natural" (noninflationary) rate of unemployment.

On balance, the changes that have taken place during our "era of intensified competition" have been beneficial to the long-term health of the U.S. economy. We are adapting, not only because there is no other choice, but also because it is part of the typical, energetic American "can do" culture.

Chairman SABO. Thank you.

Dr. Kosters?

Dr. KOSTERS. Thank you, Mr. Chairman. I would like to focus on two issues that you singled out in your invitation to us to appear here. One is on the question of whether workers' pay is keeping up with productivity growth, and the second is how much economic growth we can expect in addition without giving rise to risk of more inflation.

On the first issue, there is a well-known proposition that we should expect pay increases to be more or less equivalent to productivity growth. With appropriate qualifications and with appropriate attention to definitions, that is by and large consistent with our experience.

The graph that we have before us here this morning shows some divergence, and so do parts of the graph that is attached to my testimony. What I would like to do is to talk briefly about some of the sources of that divergence. This subject gets rather technical, and it is often necessary to look at footnotes to charts like these. I don't really want to get into it in a great amount of technical detail, but instead to describe in general terms the kinds of things that I want to focus on.

The first kind of question one needs to pay attention to is the question of whether one is looking at productivity growth and real hourly compensation for the same sector. Sometimes, for example, people will look at real income of full-time workers, for workers in the economy as a whole, and compare it with productivity growth just in the private sector. We should not expect those to be equivalent, given that some 17 percent of employees are in the government sector, where by definition the way we calculate the data, productivity growth is zero. So you need to pay attention to consistency between the sectors where both of these measures are taken.

Another has to do with the concept of what we are talking about when we talk about pay? Are we talking about money income, or wages, or are we talking about total compensation? That is very important, because nonwage benefits have been absorbing in an increasing share of productivity growth in recent years. Certainly, it can be very misleading to compare wage growth only with overall productivity growth.

Another factor that is important is to pay attention to the price indexes that are used. A frequently used price index, for example, is the ordinary consumer price index, which has apparently been used in the chart on display. When one compares data over long spans for the CPI, little attention is given to the change in the way housing costs were measured, which occurred in the early 1980's.

Now, the graph that I have at the back of my testimony shows that the housing change by itself accounts for about half of the divergence over the last 20 years for the private sector between real compensation, adjusted for that price index, and productivity growth.

Still another factor has to do with the difference between the goods and services that are currently produced by workers and the mix that they consume. One of the differences, of course, is that some of the goods that are produced are investment goods, and as it happens, some of those goods have declined significantly in price. That is another source of divergence between the two measures, compensation and productivity.

Finally, we, of course, always expect short-term divergence because we think of compensation as not being the residual claim on output, but instead we expect more profit variability and variability of other returns. So there are a variety of reasons, why the two series can diverge, and they have diverged for significant periods in the past. Recent divergences, after looking at what they are composed of, do not seem to be out of line.

Now, let me turn to the question of whether we should expect larger nominal wage increases with more inflation when we get to a range of unemployment perhaps similar to the range that we have experienced recently. I think the first thing that I would like to point out with regard to that question is that we have had a major change in the way the employment and unemployment survey was conducted. This change was introduced at the beginning of this year.

It amounts to, it seems to me, a change in the measuring rod for unemployment. What the change involved was a change in the questions on the questionnaire, a change in the way the surveys were conducted, a change in the way the data were processed, and updating for some other factors as well.

Now, all of these factors have had a significant effect on the unemployment rate level and other measures of the labor market. Just to illustrate, let me start by using as a reference point the unemployment rate that the Congressional Budget Office uses for its standardized fiscal measures. CBO used as a measure of the nonaccelerating inflation unemployment rate 5.5 percent in 1993, measured on the old basis.

Now, from an overlap sample, the BLS has estimated that the changes they introduced at the beginning of the year, changed the measured level of the unemployment rate by about .6 of 1 percent. Consequently, that 5.5 percent would translate to 6.1 percent on the new basis, the way unemployment are currently collected and reported. I think this is important to keep in mind.

There may, of course, be other factors that influence current conditions, but many of these factors suggest that markets might be quite tight in the months ahead. Average hours of work and overtime hours of manufacturing have been very high recently. The capacity utilization rate is quite high, and while it may be the case that continuing cyclical slack in many other industrial countries might tend to keep prices from rising here in the months immediately ahead, policy is about the future. We can expect that within the next year or so, presumably, more recovery will take place in those other industrial countries.

So it seems to me that growth in the U.S. economy has moved output up to a rate that is close to the level of capacity that we can achieve without raising inflation. Further increases need to be brought down to a pace more-or-less in line with what can be sus-

tained in the future. Now, it seems to me these points are not well understood by the general public for a couple of reasons.

One reason is that this recovery got underway rather slowly, and people are slow to recognize the number of additional jobs that have been created and the expansion in output that has already occurred. The second reason, of course, is the change in the way the unemployment rate is measured and the way other aspects of the labor market are measured as well.

Now, with regard to unemployment, the new measure gives the impression that the economy is performing less well than it actually is. However, with regard to employment, it gives the impression that the economy is performing better than it is. These things can easily be overlooked, even by professionals. One need look only at the editorial in the Washington Post this morning and see that the number of new jobs that they say have been created over the past year was 3.7 million.

Now, by my reading of those data, I believe the number they report is overstated by something on the order of 1 million jobs by not taking into account the change in the measuring rod. So it seems to me that is a large distortion, even for The Washington Post.

It is possible that the recent decline in the unemployment rate that we have seen, to 6 percent in the most recent month, will be smoothed out somewhat. But nevertheless, although there are uncertainties, I think we have moved up to a rate where we need to recognize the risks of more inflation. An important goal for the immediate future, I think, is to get a slowdown in the rate of output and employment growth to a rate that is more sustainable and less likely to push inflation up. Thank you.

[The prepared statement of Dr. Marvin Kosters follows:]

PREPARED STATEMENT OF MARVIN H. KOSTERS, DIRECTOR, ECONOMIC POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

THE LABOR MARKET AND THE ECONOMY

Mr. Chairman and Members of the Committee: I appreciate this opportunity to discuss trends in the compensation of the average worker and recent developments in the labor market. I will concentrate mainly on two of the issues that you identified in your invitation. The first is whether workers' real pay is keeping pace with productivity growth, and the second is how much additional economic growth the economy can be expected to accommodate without a growing risk of inflation.

Productivity and Pay

The proposition that workers' real pay gains should reflect increases in productivity, or real output per hour, is well known and widely accepted. With appropriate attention to consistent application and necessary qualifications, such a relationship is generally consistent with experience. The qualifications and consistency are very important, however, and comparisons that do not take them adequately into account can be misleading.

One important issue is whether productivity and pay are being compared for comparable sectors. For example, measured productivity growth has recently been much higher in manufacturing ban for the rest of the private economy. Consequently, average real hourly pay for all private sector employees—nonmanufacturing as well as manufacturing—could not be expected to increase as rapidly as output per hour in the manufacturing sector alone. Thus, comparisons of increases in incomes or other measures of real pay for the entire work force with productivity growth in the private sector alone are misleading. Data on all wage and salary workers show that about 17 percent of the total are employed in government, and measurement conventions assign no productivity growth whatever to the government sector. For the

work force as a whole, growth in real pay can generally be expected to fall short of private sector productivity growth as a result.

The question of what concept of pay is being compared with productivity growth is also very important because non-wage benefits have increased more rapidly in recent years than wages. Comparisons with median income, wages, or average hourly earnings usually show productivity growing faster, but money wages are only part of compensation, and non-wage benefits have been absorbing a growing share of productivity growth. The problem of comparability is often exacerbated by comparing wages of production and nonsupervisory workers with output per hour in the private sector produced by workers at all skill levels. Such a comparison not only fails to take non-wage benefits into account, but also considers only a component of the work force for which wages have increased less than for the average worker.

Several somewhat technical features of how prices are measured to obtain measures of real output and compensation have also influenced trends. Housing prices and the change in the way they were measured beginning in 1983 raise issues of two kinds. In the first place, most of the service flow from housing does not come from currently-produced additions to the housing stock, but instead from the existing stock of housing. This is one reason why the prices of goods and services that workers currently produce can diverge from prices of what they consume. The second issue with regard to housing is that a measure of housing prices that rose rapidly in response to the big increases in interest rates in the late 1970s was replaced in 1983 with a measure that did not directly reflect their decline from the early 1980s to 1993. The impact of this measurement change can be seen in Chart 1, where the most frequently used measure of consumer prices, CPI-U, is compared with a real compensation trend for which a rental equivalence measure of home owners' housing costs is used consistently throughout the period, CPI-U X1. This comparison shows that about half of the divergence in 1993 between output per hour and compensation per hour (adjusted for inflation using the regularly reported CPI-U index of consumer prices) is accounted for by the change in the treatment of home owners' housing costs alone.

It is also apparent in Chart 1 that compensation per hour, even after adjustment for inflation using a consistent definition of housing prices (CPI-U X1), has not increased as rapidly since the mid-1980s as either output per hour or real compensation adjusted for inflation using the same price index as is used for real output (the appropriate implicit price deflator). This remaining divergence is partly accounted for by the fact that prices of goods purchased by business for investment (with computers an important component) increased less rapidly than prices of goods and services purchased by consumers.

Another reason for divergence of real compensation from productivity growth is really a qualification to the basic proposition. Compensation of employees is not the residual claim on output to the same extent as profits, for example, and consequently considerable divergence often takes place for many periods, as shown in the chart. In addition, although for the particular period of time shown in the chart the total increase in output and compensation per hour is very similar when the same price index is used, they should not be expected always to be comparable, because allowance also needs to be made for relationships between productivity and real compensation in the government and non-profit sectors, as noted earlier.

In summary, non-wage benefits need to be taken into account in addition to money wages or income for relevant comparisons with average productivity increases. In addition, careful attention needs to be paid to consistency of price measures and sectoral coverage for comparisons, and short-term variations from comparable percentage changes should be expected.

The Labor Market and the Risk of Inflation

I turn now to the question of whether we should expect larger nominal wage increases, and more inflation, when less slack remains in the labor market, and whether we may be near the range in which this becomes increasingly likely. These questions are important because growth in nominal output does not produce comparable growth in employment and real incomes if higher output, measured in current dollars, is accompanied by correspondingly higher inflation. In addition, the residue of higher inflation would tend to impair economic performance and eventually lead to costly efforts to restore greater price stability.

These questions are timely because the gradual recovery from the recession that began in 1990 and the more rapid recent economic expansion have absorbed much of the earlier room for further growth at higher rates than are permitted by long-term growth in production capacity. What may be even more important at this time, however, is the significant change in the survey we use to produce our unemployment data that was introduced at the beginning of this year. The effects of this

change are apparently sufficiently important that we should regard it as a major change in our unemployment measuring rod. Distinguishing between real changes in labor market performance and changes that are attributable only to a change in the measuring rod is likely to be confusing to all but a few specialists when current data are compared with our earlier experience.

To illustrate the importance of what was actually a series of changes in the survey questionnaire and in collection and processing methods used to generate our unemployment data, I begin by using as a reference point the unemployment rate that the Congressional Budget Office used to compute potential GDP in order to estimate standardized fiscal measures, such as the federal budget deficit. For 1993, CBO used a 5.5 percent unemployment rate, measured on the old basis. The Bureau of Labor Statistics has estimated, based on an overlap sample, that its new methods add .6 percentage points to the measured unemployment rate. If we accept the BLS estimate, this means that a 5.5 percent unemployment rate on the old basis is equivalent to 6.1 percent on the new basis that we now use to collect and report unemployment statistics. This change in the measuring rod makes current unemployment appear to be considerably higher than if it were measured on the old basis.

I have used this specific reference point to show the importance of the change in the way we measure unemployment. I do not mean to suggest that I think it is more useful to think in terms of a specific unemployment rate than a range, or that 5.5 percent (now 6.1 percent) is necessarily a critical value. Many analysts probably also agree that if inflation tends to move up when the unemployment rate falls below a certain rate, that rate may change over time. The most recent experience that might be used as a guide to what rate or range is relevant is the two-year period from mid-1988 to mid-1990 when the unemployment rate was usually about midway between 5.0 and 5.5 percent. The fact that both wages and prices were rising noticeably more rapidly by 1990 suggests that the risk of inflation became important in this range.

It is appropriate to consider whether special features in the current economic environment might influence the amount of growth in employment and real output that can be achieved. Employment growth has accelerated since 1991, even though it was unusually slow when the recovery began. Average hours of work and overtime hours in manufacturing have been unusually high, suggesting limited scope for additional output expansion without more hiring. Although capacity utilization rates are also high, pressures for higher industrial prices may be delayed by continuing cyclical slack in other industrial countries. It is important to keep in mind, however, that current policy will affect performance in the future, and if domestic markets tighten further, this will come at a time when more rapid cyclical expansion abroad is generally expected.

The most significant development in the U.S. labor market during the past two decades has been the widening gap between wages of workers with different skill levels. This decline in the relative wages of the less skilled at a time when skill levels were rising for the work force as a whole is evidence of very strong demand for skills in the labor market. One implication of these developments is that policies that would raise costs to employers and discourage job creation among the less skilled should be avoided.

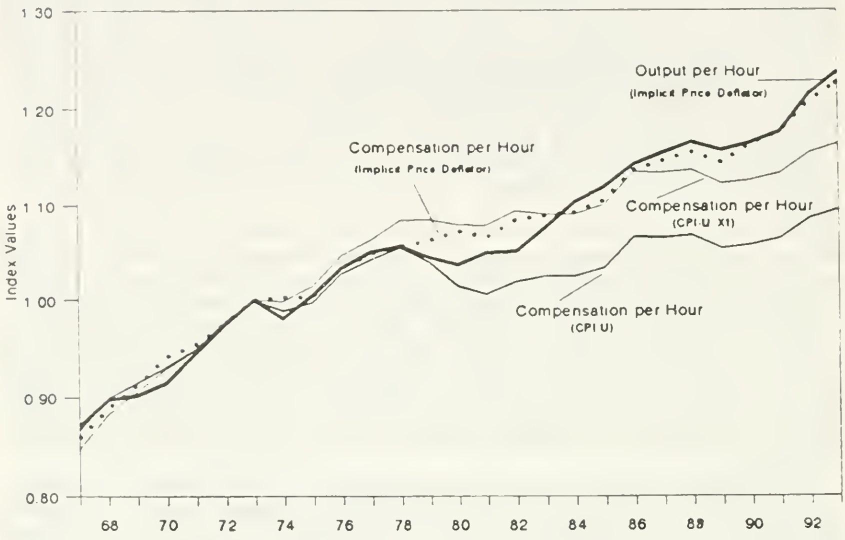
Growth in the U.S. economy has moved it up to a level at which further growth at a higher rate than the production capacity of the economy expands will pose increasingly serious risks of rising inflation. These conditions are probably not well understood by the general public for two reasons. Recognition that a strong recovery was underway has come only gradually because it started so slowly that it was initially often referred to as a "jobless recovery." The change in the way we now measure unemployment that was introduced at the beginning of the year is also likely to create a perception that the economy is performing less well than it actually is.

It is quite possible that the sharp decline in the unemployment rate to 6 percent in May overstates the extent to which the labor market has tightened in recent months. The reliability of seasonal adjustment factors that are applied to the new unemployment measure is subject to question. Nevertheless, I believe that the economy has moved up to an operating rate at which the risk of rising inflationary pressures need to be recognized. This growing risk will be mitigated only if we are successful in achieving a slowdown in employment growth from the accelerating growth we have experienced during the past couple of years.

Chart 1

Output per Hour and Hourly Compensation

The Effects of Price Indexes on Hourly Compensation



Note: Output per Hour, Hourly Compensation, and the Implicit Price Deflator are for the Private Business Sector.

Source: Bureau of Labor Statistics

Chairman SABO. Dr. Gordon.

Dr. GORDON. I am going to focus primarily on the issue of borderline unemployment rate below which it is not safe to go and I am going to say some things at the end about the growing inequality of incomes that you raised in your invitation.

Right now the American economy is in a classic boom. It boomed very reminiscent of some of the great years in our past: 1955, 1965, 1973, 1978 and 1988 are 5 years that came immediately to mind. Those, like this year, were years of economic expansion, driven by the demand for durable goods and for structures.

Automobile factories in the United States are producing full out. In many metropolitan areas from Chicago to Phoenix, the demand and supply of single-family houses is at levels we have not seen since the glory days of the 1970's. And this expansion is more impressive, because it had to fight for its life against two big negatives, that is the decline in defense spending and the large foreign trade deficit, which implies that we are losing a lot more jobs to imports than exports are creating in return, and so those employment numbers, the growth in employment over the last year are all the more impressive.

Well, if we have learned anything from the history of business cycles within the United States, which is very well recorded for the

last 150 years, this expansion is not going to peter out tomorrow. Almost no matter what the Fed does, the average length of business cycles since 1850 has been roughly 4⅓ years, and this expansion really didn't get going until about 18 months ago. So I think that the current expansion, dating it not from March of 1991, but rather from the end of 1992 when it really got cranked up is—we are right in the middle, in the period when growth is fastest. But always, we know from the past, growth will slow down by itself, and we can expect another year to maybe even 3 years of very slow, moderate growth, again, almost no matter what the Fed does.

Going to the Fed, we all know that they have raised short-term interest rates from 3 to 4.25 percent in the last 4 or 5 months. What is remarkable to me is that anybody is talking about this, because short-term interest rates always go up in business expansions, and to cite two previous examples, the Treasury bill rate went up from 5.0 to 7.2 between 1976 and 1978, and more recently the Treasury bill rate increased from 5.8 to 8.1 percent between 1987 and 1989. So what is new?

The only new thing is that the Fed is talking more about what it is doing and everybody else is talking about the fact that the Fed is talking. Is it appropriate for the Fed to raise short-term interest rates? My answer is yes. In the past, at unemployment rates like those we are likely to be seeing over the next year or 2, inflation has slowly but steadily accelerated. I view the Fed's actions as helping to flatten the peak of the economic boom of 1994 to 1995 and thus diminish both the possibility of a future recession and also to depths that the economy would fall into in future recessions. The more we overexpand, the more we are likely to come back down.

To use some technical jargon, economists have two popular words that they use for the borderline employment rate. One is the natural unemployment rate, a phrase coined by Milton Freedman in the late 1960's. Another is the NAIRU, which stands for Nonaccelerating Inflation Rate of Unemployment. I am going to use that NAIRU phrase just for shorthand.

This is clearly a key concept for monetary policy, because obviously the Fed is charged with stopping inflation from accelerating, so we would like to know what are the economic conditions under which inflation would accelerate. How do we find out what the NAIRU is? We build economic models to explain inflation and find out after we have looked at all of the different causes of inflation beyond the business cycle conditions itself and sorted those out, like oil prices and exchange rates, what is left to indicate the role of demand in the business cycle in pushing inflation up and pulling it back down?

Well, looking back over the last 30 years, after we sort out the influence of special factors, we find that the NAIRU or natural rate of unemployment is right around 6 percent by the old definition, and that the experience of the American economy in the late 1980's is completely consistent with the view that we push unemployment lower than the economy could stand. The core CPI, the best measure of inflation at that time, accelerated from 4.1 to 5.0 in the 3 years from 1987 to 1990, a period during which, as you will recall,

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by the old definition, unemployment fell to a minimum of 5.0 percent in early 1989.

So that is the prediction. Unemployment by our current definition, the new definition as Marvin said, is about—has to be raised by about half a point. So that means that the NAIRU or the borderline number is now around 6.5 percent. We went below it last Friday, and the question for us to discuss today is has anything changed that should make us more optimistic. I am going to talk about three factors that have been suggested.

The first factor is productivity growth. I have done quite a bit of work on productivity and its cyclical characteristics. One of the things we have to remember is that there are major biases or errors in productivity growth measures as we go both back before 1987, which is the base year in our GNP statistics, and as we move after 1987. And to make a long story short, productivity growth before 1987 is understated in our GNP statistics and it is overstated after 1987, and by an increasing amount as we move into the mid-1990's.

Correcting for those measurement problems, productivity growth from 1972 to 1987, that 15-year period, was not the 1.10 that you cited. It was 1.3, and since 1987 it has been almost exactly the same, 1.3 percent per year. The impression from your graph, the blue line that we are doing great is a misimpression because we are doing great in 1992–1993, after 4 years of virtually no productivity growth between 1987 and 1991. Averaging it all together, we are not doing great, we are just barely holding our own in relation to the previous 15 years.

What about slack labor markets? Wage inflation? The best measure of wage inflation to pick out of the economic report or the economic indicators is the employment cost index, including benefits. At an annual rate that was increasing at 3.3 percent in 1987, it accelerated to 4.8 percent by 1990. Again, I think due to the fact that unemployment was pushed too low, it is now decelerated back to 3.6, but it is still a more rapid rate of growth of wages than we had in 1987, so I don't see anything changing there in the direction of more modest wage increases.

Finally, the one about the slack foreign economies also that Marvin brought up. The German economy has hit bottom and is turning around. The Japanese economy has hit bottom. Those economies are going to be growing rapidly. The latest OECD forecast is showing it growing in Europe from virtually nothing last year to numbers that are going to be coming close to the American experience by a couple of years from now. So we cannot count on that factor as remaining relevant.

So to end this section, I think it is wise to be cautious, to accept the fact that pushing unemployment substantially below 6 to 6.5 percent under the new definition would lead to a very modest acceleration of inflation. The best example of what would happen is what happened in the late 1980's. That is the closest experience we have got.

Now, a few words about wage growth and inequality. As everyone knows, the period since the late 1970's has been characterized by increasing inequality. Nobody argues about that any more. Since I wrote this, there is a very nice chart that was published

in The New York Times on Sunday, which I might add, is a supplement to my testimony which shows that the real earnings for the bottom 20 percent fell by 15 percent in the last 15 years, whereas earnings for the top 1 percent more than doubled, and the groups in-between are nicely spread out, if you like nice looking step graphs, but it is not a happy picture. What are the causes?

I think an important contribution has been international trade in goods and in people. Imports have contributed to the decline in well-paying jobs in U.S. manufacturing, and immigrants, particularly low-skilled immigrants from Mexico, the Caribbean and Asia have helped to push down incomes and salary scales at the bottom of the income distribution in both manufacturing and in services.

We should not forget the much discussed problems of American secondary education, particularly in the inner cities that have also made a contribution.

At the high end, I think the best explanation is the superstar phenomenon. A simple idea that if you are a musician or a singer, the more people you can get in the stadium, the more CDs and recordings and movies you can sell, the more money you are going to make. That is nothing very subtle. Due to the electronic revolution, the average entertainment star can reach more people than formerly was true, not only in this country but abroad, and I think also the globalization of services has increased the demand for the services of investment bankers, lawyers, management consultants, a number of the people at the top end of the income distribution that are enjoying those high incomes.

Well, what do we do about this? Most economists deep in their bones believe that free trade and open trade is a good thing for consumers, and that immigration not only provides benefits in terms of a richer, more interesting, varied society, but also is something that is very hard for the government to cut off in a country. You can do it if you are an island like the U.K. and Japan, but it is very hard to do it given the geographic situation of the United States.

I think the only real solution and the direction that the government should be going in, is to push in every possible direction those programs which will help to raise the skills of people at the bottom of the income distribution and pay for it by raising taxes on those lucky people in the top 1 percent and raise them more than was done in the 1993 tax legislation. Supply side economics ratings, cuts in taxes in the early 1980's were a total failure in terms of providing productivity growth. We should learn that lesson and get taxes on the top back up to where they were before 1981.

So to conclude, I sort of like the way the economy looks now. I just came back from the Netherlands last night. And in looking at the American economy from the point of view of Europe, what are we complaining about? They are mired in a situation of 10, 11, 12 percent unemployment. They are worried to death that—it used to be Japan, but now American companies are just taking over high-tech industries, hardware, software, everywhere you look in Europe. It is American products that are market leaders. So just briefly, I am going to say something radical in the halls of Congress.

Let's enjoy this moment of contentment. America is on a roll, and let's just sit back and watch.

[The prepared statement of Dr. Robert J. Gordon follows:]

Prepared Statement of Robert J. Gordon, Stanley G. Harris Professor in the Social Sciences, Northwestern University

INTRODUCTION

The American economy is in the midst of a classic boom, like those of 1955, 1965, 1973, 1978, and 1988. Like those earlier expansions, this boom has been driven by the demand for durable goods and structures.

Auto factories located in the U.S., whether owned domestically or by foreigners, are straining to meet the demand for almost every model, and especially for minivans and other light trucks. In many metropolitan areas, from suburban Chicago ("the land beyond O'Hare") to Phoenix, developers are building single-family housing at a rate to match the glory days of the 1970s.

This expansion is all the more impressive because it has had to fight many obstacles, notably the cutbacks in defense spending and the large foreign trade deficit, which implies that many more domestic jobs have been lost to imports than have been created by exports.

If we have learned anything from the long history of business fluctuations in the American economy, it is that this current economic euphoria is not going to disappear tomorrow. In the annals of business cycles since 1850, the average cycle (peak-to-peak) lasts 51 months, *even more* in the postwar years, and during much of that time the economy is expanding toward its new peak.

Today we should ignore all those puzzles of why the current business expansion took so long to get cranked up, with very slow growth and a "jobless recovery" through late 1992. The current expansion, starting from late 1992, is only a year-and-a-half old, and it has a long way to go. Every expansion has a fast phase, which in the current one is happening in late 1993 and during 1994, echoing the classic booms of 1955 and 1965. After that, there will be a protracted period in which business indicators are reaching new highs, but the growth rate will automatically slow down.

THE ROLE OF THE FED

As everyone knows, the Fed has raised short-term interest rates from 3.0 percent to 4.25 percent since February. There has been too much excitement in the press about these actions, because they are completely normal. Short-term interest rates rise in *every* business expansion. The treasury bill rate increased from 5.0 to 7.2 percent between 1976 and 1978; it increased from 5.8 to 8.1 percent between 1987 and 1989. The only thing new about the Fed's actions in the current episode is that the Fed is talking more openly about what it is doing, but it is not doing anything new.

Is it appropriate for the Fed to raise short-term interest rates? As I will argue in a minute, the U.S. economy is currently operating at its "natural rate of unemployment," that is, the unemployment rate consistent with constant inflation. The economy currently has sufficient momentum to push the unemployment rate below the natural rate. In the past, inflation has slowly but steadily accelerated when the unemployment rate falls as low as it is likely to be over the next year or so, and it is entirely proper for the Fed to try to "flatten the peak" of the 1994-95 economic boom. The more moderate the economic expansion over the next year or two, the milder will be the recession that will inevitably follow in the late 1990s.

INFLATION AND THE NATURAL RATE OF UNEMPLOYMENT

The natural rate of unemployment is defined as the unemployment rate consistent with steady inflation, that is, an inflation rate that neither accelerates nor decelerates. The natural rate is alternatively called the "NAIRU," the "Non-Accelerating Inflation Fate of Unemployment." Clearly, this is the key concept for monetary policy, which is charged with the duty of preventing inflation from accelerating.

How do we know what the NAIRU is? Is it an unemployment rate of 5, 6, or 7 percent? In technical jargon, economists like myself design econometric models to explain the ups and downs of the inflation rate in terms of its underlying causes—not just economic conditions as represented by the unemployment rate, but also other factors that influence inflation, like changes in food and energy prices, changes in the exchange rate of the dollar, and others. Such models help us to sort out the causes of spikes in the inflation rate between special factors, like the oil price shocks of 1973-74 and 1979-80, and the normal influence of business conditions.

Looking back over the last 30 years, once we sort out the influence of special factors, we find that the ups and downs of the U.S. inflation rate are very easy to explain, and we learn indirectly from this experience what the NAIRU was in different episodes. In the Vietnam war period the actual unemployment rate fell far below the NAIRU for six straight years, and the result was an acceleration of inflation from about one percent per year in 1963 to about 5 percent per year in 1970. More recently, in the late 1980s, the unemployment rate fell to a minimum of 5.0 percent in early 1989, lower than my estimated NAIRU of 6.0 percent, and inflation accelerated right on schedule between 1987 and late 1990.

How serious was this acceleration? The so-called "core" CPI rate of inflation accelerated from about 4.1 percent in 1987 to 5.0 percent in 1990. This is not a huge change to occur over three years, but it is indicative of what would happen over the period 1994-96 if the unemployment rate were allowed to decline to the levels reached in 1988-89. Since recent definitional changes have raised the unemployment rate by 0.5 percentage points, the NAIRU is probably now around 6.5 percent, and we would expect inflation to accelerate by roughly half a percentage point per year if the actual unemployment rate were to fall to 5.5 percent.

Has anything new happened to change my view that the NAIRU is 6.5 percent under the current definition? Numerous observers have suggested reasons for optimism, i.e., that the NAIRU may now be lower than it was in the late 1980s. Let's look at some of these suggestions:

(1) **Faster productivity growth**. If productivity growth accelerates while wage changes remain moderate, then unit labor costs grow more slowly and firms can remain profitable without raising prices. However, a close look at the evidence suggests that over the period since 1987 productivity growth has not accelerated relative to the dismal record achieved by the American economy between 1972 and 1987. Corrected for measurement errors, productivity growth in the nonfarm private economy was about 1.3 percent per annum during 1972-87 and has been almost exactly the same during 1987-94. The impressive productivity growth numbers registered during 1992 and 1993 just make up for the stagnant years, 1987-91, when productivity hardly grew at all.

(2) **Slack labor markets**. The best measure of wage inflation, the employment cost index (ECI) including benefits, accelerated from 3.3 percent in 1987 to 4.8 percent in 1989-90 and has now decelerated back to 3.6 percent, still higher than in 1987. So nothing unusual has happened to wage behavior that would warrant a new optimism that the NAIRU has fallen.

A further consideration is that inflation seems to be more tightly related to the rate of capacity utilization than to the behavior of unemployment. Inflation measures changes in prices in product markets, and so it makes sense that capacity utilization, a measure of product market "tightness," would be a better indicator. The nonaccelerating rate of capacity utilization ("NAIRCU") is about 83 percent, and the American economy passed that mark several months ago.

(3) **Slack foreign economies**. It is said that monetary policy can relax because foreign economies, notably Japan and Germany, are in recession. Any shortages caused by the domestic boom in the U.S. economy can be filled by importing supplies from abroad, and there is no need for inflation to accelerate. There is a bit of truth in this idea, but it would be unwise to lean on it too heavily. The German and Japanese economies have bottomed out and will be recovering over the next two years. Thus the pressure of demand on world supplies of raw materials and intermediate goods will be increasing, not decreasing, during the period that the U.S. economy is modestly overheated.

Overall, I think that it would be wise to assume that the NAIRU for the American economy is just about what it was in the late 1980s, about 6.0 percent then and 6.5 percent under the new definition of unemployment. There is a band of uncertainty around any such estimate, and nothing much will happen to the inflation rate if unemployment stays in the 6.0–6.5 percent range. When unemployment falls below 6.0 percent, it would be consistent with recent history to expect a modest acceleration of inflation.

WAGE GROWTH AND INEQUALITY

As everyone knows, the period since the late 1970s has been characterized by growing income inequality. Real earnings for the bottom 80 percent have stagnated, while real earnings for the lucky people in the top 20 percent have increased substantially. Many books have been written about this, and we don't have time to do justice to the issue here today.

In my view, an important contributor to inequality has been the opening of world trade in goods and in people. Imports have contributed to the decline of well paid

jobs in manufacturing, and immigration of low-skilled workers from Mexico, the Caribbean, Asia, and elsewhere has pushed down wages at the bottom end of the distribution. The much-discussed problems of American secondary education, particularly in the inner cities, has also made its contribution.

At the high end, a "superstar" phenomenon has pushed up incomes. Show business and sports stars can now reach many more people through the miracles of electronics, and promoters can afford to pay them higher salaries. High incomes of CEOs, investment bankers, lawyers and management consultants in international practices, and others reflect in part the globalization of markets for service industries.

Most economists share my view that open trade is a good thing for consumers, and that immigration not only provides benefits but is hard to cut off by legislative fiat. So, to the extent that there is a solution to growing inequality, it must be in the "direction of upgrading the skills of the unskilled. A good way to pay for a massive national investment in better education and training would be to raise taxes on the very top end of the income distribution even more than was accomplished in the 1993 tax legislation.

CONCLUSION

The current economic expansion is one of the healthiest in many years. It is broad based both across industries and geographically, with the exception of Southern California. The actions already taken by the Fed will keep the economy from overheating seriously in 1995-96 and will reduce the chance that the economy will slide into a recession thereafter. Employment growth will remain strong and millions of jobs will be created. Looking at our economic situation from the perspective of two years ago, or from the perspective of Japan or most countries in Europe, we have a right to a brief moment of contentment. America is "on a roll," and let's just sit back and enjoy it.

Chairman SABO. Thank you. Let me focus for a little while on the question of the income inequality, because clearly it has been growing for 20 years or so. And while there are variations in the charts between productivity and wage changes, the data would seem to indicate that in recent years, productivity has been growing more than wages. And even within that growth of wages, the disparity is growing insignificant.

What I gather is even if we do, Dr. Gordon, what you are suggesting in terms of additional training and skills, its major impact may not be on the bottom 20, or even on the bottom 40 percent, but maybe on the middle 20, and primarily in the top 20 percent of the income spectrum in this country. And I think we have the issue of equity; as well as growth and competitiveness. Maybe we should hear from sociologists.

I think it poses a real danger for the basic fabric of democratic societies if that disparity continues to grow. Are there things other than simply additional training and skills that those of you that are here would suggest?

Dr. GORDON. I don't think you are right that the government can only cook up training programs that help the middle or the top and can't do anything at the bottom. But I think we have to define what skill-raising would mean in a much broader way. Operation Head Start can help the bottom, preventive medicine, having a real mentoring program to get adequate prenatal care for poor teenage mothers and to think of every possible way of stopping them from becoming teenage mothers with the inevitable consequence of creating more low-skilled babies for the next generation. So when I say more skills, more education, I am really thinking of sort of a broad-based set of social programs that involves a lot of pretty direct intervention.

I am not a sociologist and I am not going to design such programs this morning. There are plenty of people here and in the rest of the government who are thinking about that right now in terms of welfare reform and other related aspects. But think of it very broadly.

Dr. KOSTERS. I would like to follow up on that, if I may. I personally think that we ought to be cautious in attaching too much importance to the question of whether the skill upgrading that we are encouraging takes place in the middle or the top or the bottom. First of all, we should encourage it across the whole spectrum, in my opinion. But let me illustrate why I think we should be careful to avoid thinking of improving things directly at the bottom only. One of the phenomena that we have seen, of course, is a big rise in the relative pay of people with college, and that has meant a decline in the relative pay of high school level workers and dropouts.

Now, one way in which we could do something to restore balance would be to increase the relative supply of those with more skills. That is, we could encourage more people to attain college-level training.

We would then have a situation where there would be relatively fewer people with less skill, less schooling, and their wages would tend to rise. I think of this in terms of relative supply and relative demand for people at various skill levels. So it seems to me that how to improve the well-being of a particular group may not be closely connected to the level at which we intervene.

What has happened in the labor market is not a big increase in the relative number of people without advanced schooling. On the contrary, the schooling of the workforce has improved. What has happened is, people with little schooling have had a decline in their relative pay associated with relative supply and demand in the labor market as a whole.

One further point about relative supply and demand. I would also like to point out that on the question of the extent to which trade is responsible for depressing the wages of the less skilled, the evidence does not support this idea. I notice that the Economic Report of the President that came out in early February says that trade was apparently not an important factor. Professor Jagdish Bhagwati and I are publishing a small book soon that casts doubt on whether trade has had a significant effect on wages of less skilled workers. So in terms of the question of causes, it is not clear that trade has been a major cause.

Many scholars point to technology as the major cause of the widening skill gap. If this is correct, there is at least the possibility that current relative wage patterns could be temporary. The problem might be self-correcting to an important degree.

Chairman SABO. Let me ask this question. Do you see any evidence that the number of what we call low-skill jobs will decrease in our society? With that goes the question——

Mrs. FREEDMAN. Congressman Sabo, I think that the Bureau of Labor Statistics projections of numbers of additional jobs between now and the year 2005 show primarily what we consider to be low-skilled jobs. They are low-paying jobs, almost all service jobs, and they are, most of them, jobs in which women predominate. So we

call them low-skilled jobs because they are low pay, and we traditionally think of them as low-skilled.

However, if you look at the list and you think about the occupations and how they work, you find that almost all of them are the kinds of occupations that take independent judgment. They are people working alone, rather than on a production line under tight supervision. These are people who are security guards, building maintenance people, truck drivers, retail workers, waiters and waitresses, practical nurses, people whose decisions are essentially made without close supervision, and people who have to have good self-control, good judgment, the ability to distinguish an emergency from a normal situation, and the ability to perceive the consequences of an action.

I think maybe we ought to consider that those are high skills, and that in terms of what Dr. Gordon said, we are not training a large part of the population at the family level in very early years to develop that kind of character trait, that kind of personality to take that sort of responsibility.

Chairman SABO. What do we need to do to deal with what you call those jobs you described that are still low wage and traditionally have been.

Mrs. FREEDMAN. I would accept that working is better than not working, and especially in the American culture, working for a living, even at low pay, is preferable to not working.

Chairman SABO. I don't quarrel with that. But what strikes me is that we have had a very fundamental change going on gradually in this country where there are significant numbers of jobs that don't pay enough to live on, and I agree with you, they involve skills. The other thing I think that we do that is dreadful is we talk about good and bad jobs. And I think the psychology of that is absolutely dreadful. There are jobs that don't pay well. But somehow, we establish in our country the culture that the person who makes a grill should make more money than the person who uses it. And it may require more skill to use it than to make it. And what do we do about that?

You know, historically, our workers were to a substantial degree organized. The number of folks in organized labor has decreased substantially, particularly in the service industry. There are very few organized workers, bargaining for wages. And we find increasing disparity in that area.

Dr. GORDON. Let me tell you a couple of things not to do. How about raising the minimum wage to $8 an hour? We have a pretty good example of what would happen, because the minimum wage for low-skilled workers in France is relatively high, and they have had an unemployment rate of about 11 percent for the last 5 years. And I think that is a pretty good prediction of what will happen.

As you well know, it has been national policy of the government, business and union leaders in Sweden over the whole postwar period to deliberately compress the income distribution and the Swedish economy is in deep, serious trouble. In fact, there are teams of American economists, including a good friend of mine going over and trying to help them figure out how to get out of the mess that they have created by trying to interfere with the operation of free markets. It is really sad that supply and demand operates the way

it does. That is why they call ours the dismal science. But it is almost like trying to hold back the tides to try to come up with ways that the government could intervene with this huge tilt in the income distribution.

On trade, I don't think it is any coincidence at all that the U.S. income distribution, the distribution of earnings was flattest and most compressed in the 1940's, more so than it had been in the 1920's and much more so than it is now. Now, what was particularly unusual about the 1940's? We didn't have any trade at all. We had World War II. Trade was cut off. U.S. manufacturing was self-sufficient, and there was very little immigration as well. And I think just that historical comparison suggests that trade and immigration has got to have something to do with events in the last decade.

Something else, of course, is that we had very aggressive pro-union legislation in the late 1930's under the New Deal and so labor bargaining was most favorable to workers at that time. That gradually eroded, among other reasons, because in our country, unlike many European countries, we have a tradition of nonunion environments in many southern States, and as manufacturing locations dispersed through the postwar due to technology, due to the spread of trucking and so on, more and more manufacturers were able to jump out of a union high-wage environment into a nonunion, lower wage environment.

Again, that is something I don't see how the government in this country could revolutionize without going to European style national legislation requiring everybody to be in a union and that just doesn't seem to be on the political table at the moment.

Two things that I would suggest is a follow up to the previous discussion about college and the supply and demand factors that have raised the relative pay of people with college educations. There was an old idea that used to float around in the 1960's called the education opportunity bank in which the government would simply lend money to people to go to college and that loan would be repaid through compulsory repayments collected by the IRS on future earnings, and there is a lot of opportunity for the government to operate as a banker itself in encouraging people who otherwise would not be able to afford to go to college to have that opportunity.

And there is another old idea dating back at least 30 years that our State and local governments are fundamentally unfair and fundamentally contributing to the income distribution problem because they use sales taxes paid by financial education that would help people with the lower level of skills to upgrade those skills. And that old idea has, as its implication, that governments, whether it is Federal, State or local, should be doing more for vocational training to match what we do at the higher education level.

Dr. Kosters. I certainly agree very much with Bob's comments on the minimum wage. I agree to some degree with his comments on college. I guess I would say that maybe what we ought to think about if we are more generous, in terms of supporting loans and the like, maybe we ought to consider making assistance to some extent contingent on achievement, since that is presumably our goal rather than simply time spent in school.

Now let me come back for a moment to the question of low-wage jobs, how many there are going to be, and the distinction between "good" and "bad" jobs. You mentioned, I think rightly, that it is a dreadful psychology. I would argue that making the distinction that way is also dreadful economics. I think that there is another distinction that needs to be made. It is a distinction between the skill levels that doing a job requires and the skill levels that workers bring to jobs. We would like to raise the latter, but not necessarily the former.

Obviously, we would all prefer to see higher wage jobs rather than lower wage jobs. However, at the same time, we might also prefer to see more jobs that require modest or even quite limited skills. It would be very desirable for people with modest and limited skills if there were a lot of demand for their services. If that were to happen, their relative pay would increase to offset the declines that occurred before. It is not so much that the mix of jobs has changed over the last few years; it is much more that wages for the various job categories has changed. Thus, counting occupations and the like is not really much help on the question of what is likely to happen to the distribution of wages in the future, in my view.

I mentioned earlier that technology could potentially be helpful in restoring more balance in relative wages. The reason is that I think that computers and the like can be used to make jobs more "user friendly," to require somewhat less sophisticated skills. Most middle-aged people who try to work with computers are very grateful for user friendliness, for fewer demands on their programming skills. So I think this is an important possibility. My main point, though, is that we need to distinguish between low-wage jobs and the skill requirements that jobs place on potential workers.

Chairman SABO. Mr. Shays?

Mr. SHAYS. Mrs. Freedman, I think you were the only one who basically documented the problem, I guess, which we all accept, the other two didn't do that. But I listened to all three of you and I was left wondering if we really were talking about unemployment and so on. But it seems to me the issue of unequal income relates to the whole issue of independent contractors.

I mean it relates to a cash economy where, for instance, in my district, which is probably a higher income district, an employer of 17 employees said that 50 percent of the people of the hires will only work based on cash. And he doesn't hire them. So my second concern is just this whole cash economy.

The third one is, maybe it is more symbolic, because I realize the statistic of 1 percent of doubled income includes more than just the top executives. But when I was at NYU I remember reading a book in my MBA work, and it described how the chairman of one company was on the board of directors of another. But the extraordinary—and just how they were so intertwined and they all knew each other, and we said it was a small world. It was, because their world is small. So in other words, people compensate others who in effect then receive a benefit because they compensate them.

How do we justify $10 or $15 million compensation for executives who a few years ago they were performing, were making much less than that?

Mrs. FREEDMAN. I am not sure if I can justify it at all. But you asked, what can we do? I suppose Congress could enact a tax that would take 98 percent of all pay over $1 million, and I would guess that Michael Eisner might work just as hard for $1 million as he does for $48 million. And if you taxed all pay above a certain level or raised the tax rates, as Dr. Gordon suggests appropriately, you would bring down at least the very high executive compensation level. That really would not address some of the questions about income disparity that we are talking about today, but it would hit very hard at the headline, executive packages that have come to your attention.

Dr. GORDON. Don't forget that the top 1 percent of the income distribution earns about $600 billion, and that is a lot of money to be taxed. If you followed my suggestion to use the money you get from them to pay for prenatal care in inner cities and other programs that directly impact the bottom 20 percent, then you are actually addressing this issue.

I wanted to make one further comment, because every time Marvin says something I think of something else. Computers can make jobs more user friendly, but look at the number of computers per student in rich suburbs compared to inner-city schools. The low-income kids are going to fall behind the high-income kids even more in terms of their ability to use computers.

Don't forget when you are sitting here in Washington that fundamentally educational inequality is due to federalism and due to the fact that you have State and local financing. A number of States are trying to address this. But the Federal Government could step in with programs to ensure minimum supplies of computers in schools across the board designed in a way that would deliberately help the poorest school districts in order to try to counterbalance this terrible Federalist system that we have, at least terrible for that purpose.

Dr. KOSTERS. I think that there are many people in particular situations for whom disguising their income is a particularly important consideration. It seems to me that one thing that one needs to be cautious about in thinking about tax policy is whether high taxes will move people into a cash economy. What might be more important, however, is whether high taxes move them away realizing income in taxable form. One of the ways in which people change their behavior in response to tax changes at the upper income level is by exercising discretion on how they realize their income and when.

Mr. SHAYS. Dr. Kosters, I am having trouble following you. I am talking about people who are simply taking cash, not reported income. It is estimated that there may be a loss of hundreds of billions of dollars of Federal revenue. I mean who—I don't know who is getting this money. Is it lower incomes, is it middle incomes, is it upper incomes? What do we do about it? But I didn't expect to come and be so depressed, but I mean if your suggestion is or others is that the way we are going to deal with this is just tax the wealthy more, I don't know quite how that is going to accomplish what we want to do.

Dr. KOSTERS. I am not suggesting that. I am suggesting that there are problems at both ends of the income distribution, wher-

ever marginal tax rates are high. And let me be more explicit about that. At the lower end of the distribution, we have an earned income tax credit that is scheduled to provide earnings subsidies of up to 40 percent before it phases out and turns into a tax. After first creating incentives to exaggerate income, it becomes valuable to disguise earnings that would move you beyond the subsidy range.

At the upper end it becomes valuable to accumulate your income in some non-taxed form if your income tax rates are high. I don't know how it would affect the efforts of say, Michael Eisner. But people with high incomes are not all CEO's. I think high taxes might affect the Michael Jordans and Michael Milkens and Michael Jacksons as well, maybe by influencing the kinds of organizations they form to accumulate the money they take in.

Mr. SHAYS. Can I just ask you, Mr. Chairman, I know—okay. Thanks. What about the whole phenomenon that is taking place where everybody is being hired as an independent contractor and people are now being hired 20 hours instead of 40 hours, and some benefits aren't being paid. It strikes me that we have a real challenge in this area as well.

Mrs. FREEDMAN. You are talking about all of the contingent working arrangements that have grown very much in the past decade.

Mr. SHAYS. My nephew was hired by a large Fortune 500 company as a part-time employee working 60 hours a week, and he was hired through an agency. They are—so he doesn't receive the benefits of this 50—of this large company. That is one example of contractors hiring—developers hiring 50 employees and paying each one of them as an independent contractor so they don't have to pay worker's compensation and unemployment compensation and so on, which are all a part of the compensation equation. It is a phenomena and nobody seems to really want to address it.

I have been speaking to some of my colleagues in Congress. The administration isn't too eager to address the cash economy and neither was the previous one, or the fact that everybody is getting outside paying benefits by hiring everybody as independent contractors.

Mrs. FREEDMAN. One of the reasons why the independent contractor and contingent employment arrangement is growing is because companies want to achieve more flexibility in their costs and in their operations. In other words, they don't want to have long-term obligations to an extensive workforce. Some of the benefit costs that you were talking about can be avoided by hiring people as independent contractors or as temporary employees.

The cost of benefits and the cost of long-term obligations have risen greatly in the past decade or more, and companies under competitive pressure simply can't meet those costs. So if they are going to undertake some new enterprise or if they are going to grow in a way that they are not sure will last, their choice will be to use contingent workers one way or another, so that they are not stuck with a fixed labor cost that they can't support in 2 years if it turns out they made a bad bet.

So from the employer's point of view it is flexibility, not just to cut costs, but to be able to undertake new enterprise or develop some new business line.

From the employee's point of view, it is—it forces the employee back into a more self-reliant kind of financing for benefits and even saving for pensions and that sort of thing, because the employer really isn't taking on that social burden. But as I said before, it also creates more opportunity for reemployment when somebody loses a job.

We have in this economy more ways to get back into some kind of paying work than they do in economies where the only choice is full-time, permanent employment relationships—or nothing.

Dr. GORDON. Let me give you an alternative way of thinking about this, going back to the cash economy and the incentives that many firms are responding to to essentially employ contingent employees instead of permanent employees. Well, the government could become a national policeman to prevent all of this stuff.

You could triple the number of IRS audit agents. You could go out and find the people in the cash economy and make them pay up. That is one way to proceed. You could force employer mandates more broadly so that you couldn't escape them by setting up these contracting systems. An alternative method, and I know we are not here to talk about health care reform today, reduce the importance of paying benefits by employers by going to a single-payer system and just get around the fact that there are so many incentives today for employers to try to avoid paying benefits which largely for young people mean health care, and, of course, I will give you a little hint about which health care system I would favor.

Dr. KOSTERS. Can I follow up on that, too, briefly? I think that mandates are becoming increasingly important in terms of how they influence hiring patterns. In fact, I often wonder, for example, whether one of the reasons why we may have unusually high hours of work on average now days is that this is the first business cycle where we have had mandatory requirements for advanced notification for layoffs. It tends to make firms cautious about bringing on additional workers.

When I think about contingent employment arrangements, whether they are independent contractors or temporary services or whatever, I think of them as, in part, a very useful way in which the economy adapts to try to solve problems created by mandates that workers may not value all that much and that employers find costly. So I see these new arrangements as very useful adjustment mechanisms to cope with different legal requirements imposed at the Federal or State level.

Mr. SHAYS. Thank you.

Chairman SABO. Thank you. Let me just follow up briefly, though, because I think the question that Congressman Shays raised about hiring temporary employees to avoid paying benefits is a very crucial one. I can understand the benefit of temporaries for dealing with variation in labor force and variation of need and wanting to get around that problem. But I really do think we have a fundamental problem when it is used as a method to get around providing health care in this country, and clearly, our current sys-

tem is employer-based, and the most likely changes are going to be employer-based.

Forms of employment-based requirement plans are crucial in this country, as supplements to Social Security. I suppose it increases the importance of basic Social Security for retirement planning for most. And it just strikes me that we have to deal with that problem. I have always been skeptical of a government contracting out. That often appears to have a two-fold purpose. One is more lower-paid employees to be able to contract out and contract with someone who isn't providing health and pension benefits, and at the other end of the income scale contracting out to avoid salary limits on higher end workers. And I just think that problem is a very fundamental one and it clearly is one of the reasons why the number of the uninsured for health care is growing in this country.

Back in the 1970's, the number of uninsured was decreasing in this country, and for the last 15, 20 years the trend has been going in the opposite direction.

Mrs. FREEDMAN. Congressman Sabo, I am the director of a temporary firm, Manpower, Incorporated which last year employed about 640,000 Americans. It does offer health benefits, a generous health benefit plan, a very effective one.

Chairman SABO. To the ones that they are assigning to other companies?

Mrs. FREEDMAN. To the temporary employees.

Chairman SABO. That is who I mean, to the temporary employees.

Mrs. FREEDMAN. Those who work for 400 hours in a 4-month period, they are qualified, and they may enroll in a health benefit plan which I have just reviewed. It is quite good. They also have vacation pay and holiday pay, average for this kind of work, and they are entitled to that also if they are out on assignment from Manpower, because they are Manpower employees. They even have a stock purchase plan at reduced prices, at discounted prices.

So in terms of benefits for this company—I can't speak for the whole industry—but for this company, which is the largest in the world, there is quite a good benefits plan.

Chairman SABO. Okay. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Dr. Kosters, you referred to recent changes that were made in the procedure for determining the unemployment rate. Are you suggesting that this new method produces an inaccurate result?

Dr. KOSTERS. No. I am suggesting that it produces a different result. It is using a different measuring rod. I accept the general view that it may be a better measure in certain respects. I really have some uncertainty about that. And I think that there is a good deal of uncertainty about even precisely by how much it has increased the apparent unemployment rate as compared to the rate if we had measured it on the old basis.

I am simply making a plea for recognizing that we have changed the way we measure unemployment, and we should make an adjustment for that when we make comparisons concerning employment growth or unemployment rates now compared to in the late 1980's.

Mr. COYNE. So all in all, you endorse the new procedure for determining the unemployment rate?

Dr. KOSTERS. All in all, yes. I don't have any big criticism of that.

Mr. COYNE. Mrs. Freedman, given the changes in the labor market you described many employees today are not going to have the benefits that employees in former times typically had. Is this going to increase the demand on the government to provide pensions and health care benefits for them?

Mrs. FREEDMAN. I think it puts an increased demand on the government to provide—I am agreeing with Dr. Gordon on this, or the implication of what he is saying—to provide some sort of system or bank in which all people who work can qualify for health benefits. The single-payer system, not to be too complex about it. Because as people are working for different employers and different working arrangements and it is constant cycling, employment relationships are made and broken every day, every hour, and the system we have links health benefit access to a particular job with a particular employer. That is gerrymandering, and it doesn't fit the way the labor market functions today.

The description I gave you is a constant movement, therefore, there has to be some central clearinghouse in a sense. The single-payer system, in my view, would solve the problem of mobility, employment mobility.

Mr. COYNE. And also, the firm that you referred to, the 640,000 Manpower employees——

Mrs. FREEDMAN. Temporary employees of Manpower, yes.

Mr. COYNE. While they may have benefits, that is not the norm for temporary firms like that, is it?

Mrs. FREEDMAN. Probably not, but I don't know.

Mr. COYNE. Thank you.

Chairman SABO. Mr. Smith?

Mr. SMITH OF MICHIGAN. Thank you, Mr. Chairman. You seem to be implying that wage or income disparity is bad, and, Dr. Kosters, you suggested that maybe we could increase the number of people going to college to reduce income disparity. We could also close down all of the colleges in this country and also reduce income disparity. Do you agree? Sure, you do. I mean if we close down all colleges.

The point I am trying to make is that income disparity isn't altogether bad, if you have a low entry wage earning and you increase the earnings of everybody else, then that income disparity is going to increase and certainly that is good.

You brought up the suggestion of where we were in the 1940's, and so I would also ask you that question. Would you rather have our standard of living in the 1940's, or would you rather have our standard of living today? To paraphrase Adam Smith, he said, in his time, the very poorest of his society had more wealth than the richest persons of countries in Europe. And so, I am just suggesting that with a free market economy, wage disparity is not only something that is going to be there, but in some cases it is good. Do you agree, or could you comment?

Dr. GORDON. Let me, first of all, object very strongly to your statement that, oh, would you like to throw us back to the standard of living of the 1940's? The rate of economic growth over decades

and the degree of income inequality at any one time are two totally different questions.

Mr. SMITH OF MICHIGAN. Yes, absolutely.

Dr. GORDON. I am going to relate this back to the late Arthur Oakan's famous book called, The Great Trade-Off, Inefficiency Versus Inequality. Is it really a legitimate concept that to create a more equal society involves imposing inefficiency. That is, for instance, taxing the rich, giving to the poor, having the government in the middle taking money and wasting some of it along the way while it is trying to help the poor. Oakan was a genius for analogies and he called that the problem of a leaky bucket. The leaking bucket, as you take the money, Robin Hood-like, from the rich and trying to figure out ways of giving it to the poor.

Mr. SMITH OF MICHIGAN. I like that analogy. Tell me where you disagree.

Dr. GORDON. Well, the question is, I am becoming increasingly convinced that this idea that we have to create a more equal society through government actions, we have to make our society less efficient, I find that increasingly illegitimate. I think a society that creates a higher level of skills across the board, as I think we all agree, is a better functioning society with better interpersonal relations, with less political friction and can be a more efficient society with faster economic growth. So I am beginning to wonder, as I say, whether Oakan's great trade-off really is a trade-off at all.

Dr. KOSTERS. I agree that we should not always be thinking about only the effects of a policy on inequality. There are a couple of quite popular policies being talked about these days that would have the effect of increasing inequality. I don't happen to favor them, but not for that reason.

I think of apprenticeship for one, which as is practiced in Germany, is accompanied by very low pay for people who are involved in the program. I don't think if we were to have an apprenticeship program that we should be concerned about that aspect of it.

The other is the training mandates that are being talked about, and were initially proposed during the Clinton campaign. The effects of those presumably, most likely, for the most people would be that a government requiring employers to provide a certain amount of training for each worker would mean correspondingly lower pay, lower take-home pay for those workers. That is, the workers would tend to pay for training themselves, just like we expect workers under a health mandate by and large to really end up paying for it themselves.

So as I say, those are some policies that would have the effect of increasing inequality. I don't happen to favor them, but still——

Mr. SMITH OF TEXAS. But still, the point—I mean that income disparity in itself is not bad and you agree with that?

Dr. KOSTERS. Yes. I don't have any problem with that.

Another point that I think we often neglect is to recognize that a very great deal of income inequality has to do with movement over the life cycle of wage levels. That is, teenage workers don't earn very much, very few of them earn very much. Most people in their late, peak working years earn much more.

Mr. SMITH OF MICHIGAN. Our goal has got to be to increase the productivity of low-income entry level as quickly as we can and increase that productivity in relation to the rest of world.

Mrs. Freedman, let me ask you a question.

Mrs. FREEDMAN. Can I say something before you do?

Mr. SMITH OF MICHIGAN. Yes.

Mrs. FREEDMAN. You know, one of the problems with inequality is the ugly situation, sometimes ugly if you face it, that we essentially are reflecting the values of the society when we pay some people very little. Day care workers are paid very little.

Mr. SMITH OF MICHIGAN. None of us favor inequality, but we shouldn't disfavor wage disparity.

Mrs. FREEDMAN. But it is reflective of the society's value placed on child care that we pay child care workers so little. We value their work so little. In a sense we are looking at ourselves and saying, we don't really value children, we don't really value social care for elderly people in nursing homes, because we pay so little for that.

Mr. SMITH OF MICHIGAN. Which leads sort of into my next——

Mr. SHAYS. Will the gentleman yield? Does it say that we don't value or is it just basically supply and demand, that there are people who are willing to work at that wage?

Mrs. FREEDMAN. Well, that is true. There are people who are willing to work at that wage. But it also means we don't think very much of the service they provide.

Mr. SMITH OF MICHIGAN. I think that is partially a government attitude and where we have gone in some of our different government programs. But before my red light goes on, let me ask you about part-time work, contract workers.

Is most of the reason for that government laws and government regulations?

Mrs. FREEDMAN. The reason for it may have a great deal to do with the benefit load, and that is related to government regulations.

Mr. SMITH OF MICHIGAN. I am sorry, what do you mean by that?

Mrs. FREEDMAN. Well, the kind of regulation, ERISA, for example, which requires that all employees be covered by certain benefits if any are. Also, the taxes, Social Security taxes and other taxes, which tend to make the wage that an employer pays more rigid, more fixed, a fixed labor cost that the employer can't avoid.

Mr. SMITH OF MICHIGAN. And workers' compensation and family leave.

Mrs. FREEDMAN. Yes. It makes employment more expensive.

Mr. SMITH OF MICHIGAN. What is it, if it is not government?

Dr. GORDON. All I wanted to do is just reemphasize that part of this government load that these employers are trying to escape is related to the rising relative price of medical care. I wanted to go back—I wish I had it right in front of me. There was a very good New York Times op-ed column by James Togan, an economist, early in the spring pointing out that it is a total coincidence of history that the United States connects medical care benefits with employment and no other country does that.

I sort of knock the Europeans and said they are envious of our high tech and our software and our hardware, but let's not forget

that Europeans shake their heads in amazement at two aspects of American society and American government which they find incomprehensible, and that is the health care problem which we have been talking about and gun control. And I think if you took a poll in Europe of the two big reasons people would not like to live in the United States, those are number one and number two.

Mr. SMITH OF MICHIGAN. Is the reason for this, the blue line and the red line difference over there, that up until the last 3 years the increased productivity of the United States trailed those of any other industrialized country in the world? And I suspect not keeping up to the pace of productivity growth of in other industrialized countries is part of the reason for that widening gap. Is that true?

Dr. GORDON. No, no, there is no widening gap. Let me point out this excellent chart that we all have in front of us from Dr. Kosters. Here is a definition. People learn this in elementary economics. If productivity really grew faster than compensation, and they were both being measured in the same way, then we would have noticed a very sharp reduction in the share of national income earned by labor, and we haven't. And that is because that blue line and that red line are not being measured consistently and when you do it right, they lie right on top of each other. In fact, the share of labor in U.S. national income is something like 71 percent and it is higher than it was in the 1940's, 1950's and 1960's. It went up at the beginning of the 1970's and it has never come back down again.

Mr. SMITH OF MICHIGAN. I was going to say if we have a single-payer system, won't we see more entrepreneurs start their own small business that aren't going to be saddled with that additional burden?

Dr. GORDON. You would see a totally healthy movement away from people making employment decisions, both the workers and the firms, on the basis of whether they are going to lose their health care or whether health care benefits in one place are better than another. That is just totally irrelevant to the employment decision and people shouldn't have to be forced to go through that, and yet they are. It is up to you guys to fix it.

Mr. SMITH OF MICHIGAN. Thank you, Mr. Chairman. Thank you. I really enjoyed some of their answers. Other answers I would like to talk more about.

Chairman SABO. Inherent in your last suggestion is the willingness of our country to have a significantly higher tax system than what we have today; is that not accurate?

Dr. GORDON. I cannot believe that the Clinton administration dropped the balance and lost the chance to tie health care reform to the introduction of a value-added tax, higher energy taxes. There are a lot of ways that you can raise money to pay for this. But to go to employment taxes in an environment where we are struggling to find ways of creating good jobs for people seems to be shooting one's self in the foot.

Mr. SMITH OF MICHIGAN. Mr. Chairman? But a value-added tax, don't you agree that a value-added tax is simply a consumer tax? Isn't it a hidden tax on production passed on to the consumer? We have a value-added tax in Michigan with our single business tax.

Dr. GORDON. That doesn't bother me at all because I am perfectly happy to tax the rich more through the income tax.

Mr. SMITH OF MICHIGAN. No, no, this is a sales tax on the poor. It is a more unfair tax to the poor than it is to the rich, I would suggest.

Dr. GORDON. It doesn't bother me at all.

Mr. SMITH OF MICHIGAN. It doesn't bother me if they don't raise it.

Dr. GORDON. It is a good way to collect money and if you use it to pay for health care you are going to benefit a lot of people at the bottom of the income distribution system and eliminate a lot of insecurity.

Chairman SABO. I am curious about this question of the relationship of unemployment to inflation and when we start pressing inflation buttons. What really is full employment and particularly as it relates to the number of people who do have temporary employment? We have an incredible number of people with part-time employment, and my sense is that rather than being higher, it would seem to me logically that the number should be lower in terms of the unemployment rate before the Fed and others get concerned about inflation.

Let me give you an example. In my home State of Minnesota our unemployment rate was 4.2 percent in April, and in the Minneapolis/St. Paul metropolitan area it was 3.3. And I still regularly run into all kinds of folks who are clearly underemployed, lots of folks in the labor market are having a tough time finding jobs. We had significant—I find no great pressure to increase wages for lower income workers. That is not happening. I continue to find great disparity in wages paid for service jobs between the center city and suburbs, and that hasn't changed.

You know, if these numbers applied nationally, I expect the Federal Reserve would be in a panic.

Mrs. FREEDMAN. Congressman Sabo, that was the gist of what I was describing when I said that wage setting practices and the changes in the way the employment market functions have really reduced NAIRU, perhaps to 5 percent. The reason is more people are cycling through jobs and the wage setting rigidities, the escalations of the past and wage imitation of the past is gone.

Now, obviously there is some point at which you will get wage inflation. I think it is considerably lower because of the change in practices. The studies that Dr. Gordon referred to—setting higher NAIRU—are based on 30 years in the past. What I am saying is that institutional arrangements have changed in this decade. It is gradual, but it has now created really a different landscape so that wage inflation will not ensue as unemployment falls.

Dr. GORDON. Since I am being mercilessly attacked here, I think partly it is my fault because I wrote what I wrote. But we are emphasizing the connection between inflation and unemployment entirely too much. Actually, if you let the computer choose which measure or indicator of tightness it likes the best in predicting inflation, the capacity of the utilization rate wins hands down, and we are now at capacity utilization rates very similar to those reached in 1978 and 1979, and we know what happened to inflation rates at that time. So we can't just talk about wages in the

labor market, because after all inflation measures the rate of increase in prices, of products, of goods and services and the tightness of the product market is what really matters for inflation.

Wages often just follow along. If product markets are tight, the wage increases will come in tandem and they certainly did in the late 1980's.

Mr. SHAYS. Will the gentleman yield? Just to follow up on that point, it strikes me that what we really need to do, then, is to increase the capacity of our Nation to produce, and I look at our tax laws and say what do we have that encourages that and what do we have that discourages that? I am less concerned with consumer tax than my colleague is. But I wonder, for instance, why we don't have—give incentives to industry to build new plants and equipment and allow them to expense it more quickly. You know, or something else similar.

Dr. GORDON. You are playing a very nice tune. I like the melody.

Mr. SHAYS. May I just follow up with one other point? When I go through Bridgeport, Connecticut, years and years ago it was a thriving industrial center where people had jobs. Today they don't have jobs. The kids, the kids don't see their fathers work. It is a dead future for so many.

Dr. GORDON. What I was going to say in response to your first comment is that a surprisingly broad spectrum of economists across the political spectrum agree that within the last 10 or 15 years this economy has consumed too much and has had a set of policies that are pro consumption and anti-investment, and, of course, you have heard this a million times in Congress, but the government deficit is what lays behind a low rate of national saving and indirectly makes real interest rates higher than they would otherwise be and thus discourages investments.

If you want to raise national capacity to produce, why don't you start at home by putting on a value-added tax, doubling tax rates on the rich and collecting a whole lot of revenue.

Mr. SMITH OF MICHIGAN. Will the gentleman yield? I want to clarify my position on the value-added tax. I favor a value-added tax. What I fear is the gradual increases that have occurred in Europe because it is an easy tax to increase. This is because the tax is sort of hidden. As far as a good, fair tax nationally, a value-added tax is good. Our experience in Michigan hasn't been so good.

Dr. GORDON. We are going to push economic activity out of Michigan if you do it just in that State.

Mr. SMITH OF MICHIGAN. Then I, of course, disagree with the single-payer health care that you are suggesting.

Chairman SABO. Let me come back to this question of salaries. I happen to be a strong advocate of significantly increasing the minimum wage. I, frankly, don't know any alternative to jump starting the bottom end of the wage scale. I do not know how economically you make the argument that we should not raise the minimum wage if somebody is working full-time and cannot support a family, and somebody who is working full-time is actually in poverty in this country if they are working at the minimum wage. I suppose there is some progression upwards over a period of time, but that is less and less the case, particularly in urban centers.

I come from a city where the most fundamental change I have seen over the last 15 or 20 years is not a change in the relative funding of government programs, but the change in the income of the people living in the city. That is the most fundamental change we have. And we increasingly, as we deal with the budget here, we increasingly have public subsidies going to people working full-time. And maybe if that is a conscious policy and if we are willing to do it, that is fine. But we do it in a very uneven fashion.

Some programs apply uniformly to people but many do not. Probably one of the biggest expenses is housing. And there if you get a voucher and your costs are limited to 30 percent of income. At the same time somebody across the street with the same income and no voucher is paying 50 or 60 percent of income for housing.

I suppose we could have a national policy of significant supplements to income for people who are working, but I don't see that on the political horizon. We are not willing to deal with taxes in that kind of fashion to pay those kinds of subsidies. But even beyond that, I am not sure that if somebody is working full-time that they really should have to be dependent on the government for food and housing and have to deal with a variety of bureaucracies to get those very basic necessities of life when they are working full-time. But that is the fact in urban America today. And I don't know how you could get at it other than by a significant increase in the minimum wage.

It seems to me that to deal with some very fundamental problems in this country, either you have to do something at the private level to get that salary structure going at the bottom, or else you have to do something much more comprehensive in the public sector in terms of support of people than we are doing today.

Dr. GORDON. When I made my comment about minimum wage, I was opposing a radical one-shot increase that would bring the United States up to say the French level. I am not, however, against increasing the minimum wage for a couple of reasons.

First of all, of course, the nominal minimum wage was held fixed throughout the Reagan years and was allowed to erode considerably in real terms. So one benchmark is to get the minimum wage back up in real terms to where it was in 1981, and that will take considerable increases, and they should not be done all at once. They should be phased in to minimize their negative impact on employment.

There is a very intriguing study that two Princeton economists have done. You may have heard about it. They are raising doubts that there are any employment effects at all of modest increases in the minimum wage. They did a study of fast food restaurants on the Pennsylvania and New Jersey side of that State border, and apparently I forget which State it was that had a considerably higher minimum wage than the other and they tracked employment over 2 or 3 years in these fast food restaurants and found no difference at all by that increase in the minimum wage. So I agree with the thrust of it; I think that is one way the government can raise incomes at the bottom and I think the negative employment effects are typically exaggerated, but you are probably going to disagree.

Chairman SABO. Let me give you an example. People who work in fast food in our city are paid $5 an hour, generally. If you go out to our western suburbs, they are paid $6.50 or $7 an hour.

Dr. GORDON. Supply and demand.

Chairman SABO. Yes. Out there folks——

Dr. GORDON. Those kids have more options. They don't have to work for $5 an hour.

Chairman SABO. But quite often it isn't simply kids working at $5 an hour. It is the adult trying to make a living beyond the part-time needed for the kid in the more affluent family trying to earn a few extra bucks. There are folks living off those salaries.

What we discover is as you get to the more affluent parts of our cities parents drive the kids out to the suburban areas to get the $6.50, $7 an hour, while the inner-city kids don't have those options of transportation. But, the hamburger price is not different from one place to the next.

Dr. KOSTERS. Mr. Chairman, on the minimum wage I do disagree with Bob's suggestion. I think that most economists, analysts who have looked at this question, are agreed that you don't make very much impact on the income distribution by increasing the minimum wage. The major reason is that a very large fraction of those who are working at minimum wage levels are teenagers, and these teenagers tend to have parents who are in their high earning years or peak earning years in families, and those families are doing better than the average family by and large. So it is not a very effective way of redistributing income.

With regard to recent studies, the two studies that Bob mentioned, I should first say are really excellent, high-quality studies. I think the conclusions are wrong because they haven't looked at the right question, in my opinion, but they really are first class, excellent studies. So I don't really think that they change very much how we should think about the employment effects of the minimum wage.

The big question is not so much how many people are employed at McDonald's or whatever sort of fast food chain. The question is what happens to total employment of youth rather than just those in fast food chains.

Chairman SABO. It is partially food places, but it also carries over in substantial other parts of our service industries. And in your urban centers, that is where the growth of employment has been. And the change is just dramatic that you see over a period of time in the kind of jobs that people have.

I would also suggest that it probably has a significant relationship to the greater difficulty for some kids going on to college than used to be. The proportional cost of salaries changed substantially over a period of time. It also has an effect in relationship between male-female students.

I suspect the male student finds it much easier to find a high paying summer job, part-time job than female students do who end up in the more typical service jobs at the lower salaries.

Mr. SMITH OF MICHIGAN. Excuse me, Mr. Chairman. A study done in Michigan on wages of auto workers during the 1970's showed that increased salaries for those auto workers and the re-

sulting increase in prices they charged for cars had no effect on the number of jobs during the 1970's. But Dr. Gordon——

Dr. GORDON. I want to go in a different direction, because you mentioned now several times the problem of creating employment and good jobs in the central cities.

We heard about the devastation of Bridgeport, Connecticut from your colleague. Why don't more employers set up shop in urban America, particularly in low-income areas? That brings me back to the other thing that Europeans don't like about our society and that is guns and violence and people are afraid to set up shop in urban America.

The Congress has been wrestling with this for many years and I don't have anything very new to add, other than reminding you that one reason our cities and our metropolitan areas look very different than they do in Europe is that we have had 30 or 40 years of subsidization by the Federal Government of the interstate highway system and a set of national policies that encourage wealth to escape from the middle of the metropolitan area and go to the periphery, and it is very easy for me to make a list of things that will undo that, starting with redistributing national resources from highways to mass transit.

Again, that is a whole different set of issues that we came here today to discuss.

Mr. SMITH OF MICHIGAN. How does work ethic fall into the problem? Is that part of it or not?

Dr. KOSTERS. Well, I think work ethic may be part of the problem, but I think that practical decisions on many of these questions are important. Suppose, for example, that you were in this general area and you were thinking of setting up some sort of production operation that would draw on lots of young people with very little skill. One thing that you might ask yourself is: Where is the minimum wage likely to be raised? In the District of Columbia, or suburban Virginia, or suburban Maryland?

Well, the history is that the minimum wage is typically higher in DC than in the surrounding suburbs. So it seems to me no surprise that people who want to hire people at that level of skill in some sort of production operation are more reluctant to locate where the prospect is that the costs will be higher. So I think that the whole business climate, not just the minimum wage is important with regard to these kinds of location decisions.

Chairman SABO. Mrs. Freedman, Dr. Kosters, Dr. Gordon, thank you very much. We appreciate your taking the time to be here with us today and your thoughtful testimony, and we will—Mr. Kasich has one question.

Mr. KASICH. Just one question to the panel, and that is the issue of job training. I am of the view that these government job training programs really have not succeeded, and I am of the view that increasingly that what we really need to do is to provide real incentives to employers, perhaps created at the State or local level, real incentives to employers to take people who don't have skills, train them and then have somehow the incentive applied to not just the training of workers, but the hiring of them, because I think we have one program now where they are supposed to take people in and train them and what they do is they just use it for summer

employment and it is kind of like a government subsidy for them to have a larger workforce.

Is it your sense that in order to really give people the kind of skills they need, that we should break from government training programs and design a program for employers to actually train at the local level, and are there any good studies that indicate that things along this line will work?

Mrs. FREEDMAN. Congressman Kasich, I agree——

Chairman SABO. It took me years to learn that difference between Kasick and Kasich, and I finally learned that.

Mrs. FREEDMAN. Congressman Kasich, I think maybe it should go back one step, though. Back to the United States Employment Service and the State employment services. If the Employment Services of the States were to redesign the way they function, stop considering themselves a welfare agency to distribute payments to the unemployed—which is essentially how they are operating today—payments either for training or for unemployment compensation, but instead to view the clientele as corporations in need of workers. The Employment Service should connect to corporations in need of workers to develop assessment tools to assess people's fundamental skills as well as specific skills. Then the Employment Service should work with the employer, who is the true client, in developing some training, either inside the employer's facility or outside the employer's facility, but always connecting to the real client who is the employer.

That is what the United States Employment Service could do to get a system going, which as you described, would connect to actual employment opportunities and make it less of a welfare income distributing system or make-work system. That is the way to go. And we certainly have the capability.

Dr. GORDON. Let's not forget the other part of the equation. It may be that putting too much emphasis on training for specific skills is not what this society really needs for the bottom half, but rather go in the direction of national standards for secondary education, for what kids have to learn. This is partly in terms of competing with countries abroad that have higher levels of achievement in math and science, and also I go back to what I said before you came in, an that is the government can do a lot more in the form of an educational opportunity bank to lend money to people who could not otherwise go to college and then collect the repayments through the IRS, contingent on future income gains that are created by that education.

Dr. KOSTERS. Just to follow up on that very briefly, I would really question whether we should put more funding into the employment service. I think that the 600,000-person temporary services operation, the company of which Audrey is a director, is really a strong testimony to the significance of a private sector innovation in providing jobs for people, some temporary, some leading to permanent employment. It is hard to see a comparable role for the U.S. Employment Service, no matter how we structure it.

Mr. KASICH. You were talking about State employment services, weren't you?

Mrs. FREEDMAN. Yes.

Mr. KASICH. See, I have a proposal that would take all of the job training programs, consolidate them into a block grant, send them to the States and force the legislature to pass a plan that would show exactly how they would take the money and use it to connect the unemployed and unskilled with employers and then create a system where employers have incentives to take these people and give them skills rather than to train them in some—with some government program and then they end up not getting a job.

Mrs. FREEDMAN. But Congressman Kasich, that will always be pushing a noodle, a wet noodle, until the State employment services, in the very details of the way they operate, see the employer with jobs and needs as the client. Otherwise you will just be funding training programs or a training program. Unifying it won't do anything until that connection in detail, in every detail, the way it operates. I don't mean a slogan, I mean changing the entire operation of the employment service.

Mr. KASICH. Thank you, Mr. Chairman.

Dr. KOSTERS. Could I make one further comment? It seems to me that there is a kind of dilemma that you face. I think you correctly indicate that returns from many Federal training programs have been very low. It seems to me these results are enough to make one ask the question whether much of those funds devoted to training programs should simply be used instead by the Federal Government to reduce business taxes.

Might we not have a better outcome under those circumstances? One response would be to say well, some of our programs aren't intended really to earn an economic return. They are intended to give a second chance to the most disadvantaged among us. Well, in that case maybe we should limit them more tightly to that kind of role.

Chairman SABO. Thank you very much.

[Whereupon, at 12 p.m., the committee was adjourned.]

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ISBN 0-16-044741-0

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